Tax: Optimal Use Of The Estate Tax Marital Deduction After 1981

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Optimal use of the marital deduction aims at minimizing the combined estate tax costs in the estates of the first to die and of the surviving spouse. The resulting savings will normally inure to the benefit of the parties' objects of bounty, e.g., children and grandchildren, but occasionally to others.

This article undertakes to provide general decision rules for determining the optimal use of the estate tax marital deduction in certain basic fact patterns which the estate planner will encounter in practice in view of the 1981 Tax Act.

It must be recognized that the optimal use of the marital deduction cannot be completely reduced to precise rules. Any general rule of thumb is necessarily subject to modification based on such factors as financial need, propensity to consume or conserve the earning power of the survivor, the probability of remarriage of the survivor, the age and health of the parties, as well as their personal relationships.

Three Traditional Approaches to the Marital Deduction

As we will see below, the optimal use of the marital deduction may lead to an approach which differs from the following three conventional approaches:

a) *Estate Equalization:* Leave an amount to the spouse which will equalize the estates so as to equalize the marginal tax rates. This rule is now irrelevant with the new unlimited marital deduction, since, if used, only the survivor's estate is subject to tax.

b) *Maximize the Marital Deduction:* Leave the spouse the Adjusted Gross Estate (AGE). This approach is more rational than ever since marginal estate tax rates are only mildly progressive (the rate can vary only from 37 to 50 percent after 1986).

c) *Unified Credit Maximization:* Leave the spouse an amount needed for the first estate to utilize the unified credit fully. With the tax-free amount being increased to $600,000 by 1987 more care should be taken to ensure the use of the credit.

The New Marital Deduction

As every estate planner knows, a marital deduction is allowed of up to the adjusted gross estate for property "passing" to the surviving spouse, which is not a "terminable" interest, and which is includable in the estate of the first to die (IRC 2056(a)). The minimum interest required in the surviving spouse is a life estate coupled with a general power of appointment (IRC 2056 (b) (5)) except for "qualified terminable interest property." The latter is property in which the surviving spouse only has a life estate, but which the executor by election may qualify for the marital deduction by making it includable in the estate of the surviving spouse (IRC 2056 (b) (7)).

Assumptions Made

In order to construct specific decision rules (which may then be adapted to the unique circumstances at hand), it is necessary to decide on the assumptions underlying the rules. The following assumptions are made here for convenience:

1. The first spouse to die, dies after 1986.
2. The surviving spouse does not remarry.
3. The couple has descendants.
4. No charitable contributions are made.
5. State inheritance and/or estate tax consequences are ignored.
6. Property values remain constant.

When First to Die Owns All Assets

The easiest fact pattern to work with is when the first spouse to die has all the assets and the surviving spouse has none up to that point.

If we call the Adjusted Gross Estates of the first to die and the survivor AGE_1 and AGE_2 respectively, the following rules emerge:

I. *If $AGE_1 \leq \$600,000$ no marital deduction is needed*

Since $600,000 is the exemption equivalent of the unified credit of $192,800, no estate tax will be due in the estates of either spouse, whether or not the surviving spouse inherits. Of course, the needs of the survivor may still dictate a bequest of all or part of the preceding estate.

Example:

H has an AGE of $600,000. He is 70 and W is 50. H thinks W may remarry and would like to ensure that his assets will go to his only child in full rather than be shared with W's potential second husband. H can set up a testamentary trust to pay W the income until death or remarriage, remainder to his child. The bequest to W will not qualify for the marital deduction, being terminable, but due to the unified credit no estate tax will be due in H's estate. Furthermore, there will be no tax due on the termination of the trust by W's death or remarriage.

II. *If $AGE_1 > \$600,000$, the marital deduction should be AGE_1 - \$600,000.*

Utilizing the full credit in the first estate will not only reduce the estate tax to zero in the first estate but will minimize the estate tax in both estates.

Examples:

H owns $1,000,000. As long as he leaves W at least $400,000, there will not be any tax due in his estate. However, if he leaves W more than $600,000, her unified credit will not cover the bequest, assuming she still has it. W may, of course, receive a life estate and special powers of appointment (such as a power to invade corpus subject to an ascertainable standard), in the property ultimately going to her descendants. H should consider a lifetime gift of at least $400,000 in case W dies first, in which case she can pass her share tax-free to children and grandchildren.

b) H owns $1,500,000. His will sets up two trusts, the marital deduction trust (the "A" trust) and the family trust (the "B" trust). $600,000 goes into the B trust in which W is the life tenant and their children the remaindermen. The property in the B trust does not qualify for the marital deduction, but passes to the children tax free because of the unified credit. The rest, or $900,000 less expenses goes to the "A" trust which qualifies for the marital deduction by giving W a life estate plus a general power of appointment. In addition W should have powers to invade corpus of the A trust only, so that any withdrawals of principal are made from property included in W's estate. If the value of the A trust is no more than $600,000 at W's death, no estate tax is due on W's death either.

When First to Die Owns More than Survivor

The second type of fact pattern is one where $AGE_1 > AGE_2$, with AGE_2 greater than zero without a marital bequest from AGE_1, i.e., both spouses own property, but the first to die owns more.

III. *If $AGE_1 + AGE_2 \leq \$600{,}000$ no estate tax is possible, regardless of the amount left to the surviving spouse.*

Example:

W owns $400,000, H $200,000. W's estate does not need the marital deduction, since the unified credit absorbs any tentative tax. She must nevertheless make the decision of leaving her property to H or directly to her children or grandchildren.

IV. *If $AGE_1 + AGE_2 > \$600{,}000$ the full unified credit should be utilized in the first estate.* (Similar to II. above)

Example:

H owns $800,000, W owns $300,000. The unified credit will cover the first $600,000 in H's estate. Thus H should not leave her more than $800,000 less $600,000 or $200,000. He may, of course, give her the income and special powers of appointment over the property he passes directly to the younger generations. Even when H's estate fully utilizes the unified credit W's estate will be subject to estate tax.

When First to Die Owns Less Than Survivor

V. *If $AGE_1 \leq \$600{,}000$ no marital deduction is needed.*

IV. *If $AGE_1 > \$600{,}000$ a marital deduction of AGE_1 - $600,000 will reduce the estate tax in the first estate to zero, but will increase the combined tax.*

Since the maximum rate is only 50 percent, however, the deferral will invariably be advantageous, due to the time value of money.

Concluding Observations

1. The above decision rules may be modified based on such factors as financial need, propensity to consume, earning power of the survivor, probability of remarriage, the respective health of the parties, etc.

2. Because the marital bequest is not elective by the executor (except for "qualified terminable interest property"), but is made by will, the decision should be reviewed periodically, particularly when there are changes in circumstances or tax laws.Ω

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